

REPORT OF EXAMINATION
OF THE
STATE COMPENSATION INSURANCE FUND
AS OF
DECEMBER 31, 2006

Filed December 10, 2007

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San Francisco, California
September 29, 2007

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

STATE COMPENSATION INSURANCE FUND

(hereinafter also referred to as the Fund) at its home office located at 1275 Market Street, San Francisco, California 94103.

SCOPE OF EXAMINATION

The previous limited-scope examination of the Fund was made as of December 31, 2002. This examination was scheduled to cover the period from January 1, 2003 through December 31, 2005. However, due to numerous issues relating to the Fund's Group Administrators Program, potential conflicts of interest for two previous Board members, and the March 2007 decision by the Fund's Board of Directors to terminate its President and a Vice President, the California Insurance Commissioner ordered a separate operational review of the Fund, and the examination period was updated through December 31, 2006. The operational review, which was conducted concurrently with the financial examination, was performed by the firm of RSM McGladrey, Inc. (RSM). This examination report is limited to findings from the financial examination. RSM will issue a separate report covering the operational review.

The present examination included a review of the Fund's practices and procedures, an examination of management records, tests and analyses of detailed transactions, and an

evaluation of assets and a determination of liabilities as of December 31, 2006, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Fund's operations were reviewed, including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; business in force by states, loss experience; and sales and advertising.

SUMMARY OF SIGNIFICANT FINDINGS

On March 20, 2007, the Fund announced the resignations of its President, James Tudor, and a Vice President, Renee Koren, who was responsible for Underwriting, Communications, Human Resources, Safety & Health and Group Programs. The Board of Directors then appointed Lawrence E. Mulryan as the interim President. Subsequently, the Board elected Janet Frank to replace Mr. Mulryan and become the new President. Ms. Frank assumed her position at the Fund on October 9, 2007.

During this examination's review of the Fund's corporate governance, several weaknesses were noted. Following are some of the more serious weaknesses:

1. The Fund's Board of Directors lacks sufficient resources to provide the oversight necessary for an insurer of the Fund's size and complexity.
2. The Fund's Internal Audit Department is not independent.
3. Absence of the positions of Chief Financial Officer, Chief Operating Officer, Chief Information Officer and Chief Investment Officer.
4. Potential conflicts of interest with two members of the Board of Directors.
5. Lack of controls over accruals, the classification of expenses and encumbrances.

Although the Fund was unsuccessful in introducing legislation in 2007 that would address some of these issues, the Fund stated that it will reintroduce legislation in 2008. Some of the

proposed changes include increasing the size of the Board of Directors, creating committees of the Board and creating additional exempt management positions.

For a further discussion of corporate governance, including corrective actions taken by the Fund, see the Management and Control section of this report.

SUBSEQUENT EVENTS

The Fund's Board of Directors initiated an independent investigation of the Fund last year to review the Group Association Programs and related internal controls among other internal operations of the Fund. This investigation continues and a referral was made to the California Highway Patrol (CHP), which has jurisdiction over state agencies regarding certain activities. The CHP, CDI, and the San Francisco District Attorney's Office formed a task force to coordinate efforts in the investigation of potential criminal misconduct by former employees.

On May 22, 2007 a class-action lawsuit was filed through the Superior Court of the State of California by Acro Constructors on behalf of all California employers insured by the Fund against the following defendants:

- State Compensation Insurance Fund
- James C. Tudor
- Renee Koren
- Frank DelRe
- Kent Dagg
- John Dunlop
- Charles Savage
- Western Insurance Administrators
- Shasta Builders Exchange
- Shasta Builders Exchange Community Fund

The suit seeks damages based on: (1) negligence, (2) breach of fiduciary duties, (3) aiding and abetting, (4) conversion, (5) interference with prospective economic advantage and (6) violation of Business and Professions Code Section 17200, Et. Seq.

The lawsuit specifically alleges that disbursements made under the group insurance program to group administrators were concealed from the policyholders and were not negotiated in good faith or at arms length. The lawsuit further alleges that the fees paid to “business run by” defendants Frank DelRe and Kent Dagg had “little or no value to the insurer or its policyholders.”

FUND HISTORY

The Fund’s organization and powers are defined by California Insurance Code Sections 11770 through 11805. The Fund was created by the California Legislature in 1914, concurrently with the enactment of the first compulsory workers’ compensation laws in California, to assure California employers of the availability of workers’ compensation coverage at the lowest possible cost.

MANAGEMENT AND CONTROL

Pursuant to California Insurance Code Section 11770, the Board of Directors of the Fund is composed of five members, all appointed by the Governor, one of whom shall be from organized labor. The Governor appoints the chairperson who serves at the pleasure of the Governor. The Director of Industrial Relations, the Speaker of the Assembly, and the President Pro Tempore of the Senate, or their designees, are ex-officio, non-voting members of the board, and are not counted as members of the board for quorum purposes or any other purpose. The term of office of the members of the board, other than that of the Director of Industrial Relations, the Speaker of the Assembly, and the President Pro Tempore of the Senate, is five years, and they hold office until the appointment and qualification of their successors.

As of December 31, 2006, there were only three voting board members serving due to the resignations of Frank DelRe and Kent Dagg in 2006. A fourth voting member, Sheryl Chalupa, was appointed in July, 2007. Ms. Chalupa is President and Chief Executive Officer of Goodwill Industries of South Central California. As of the date of this report, one voting board

position remains open. A listing of the directors and principal officers as of December 31, 2006, as well as subsequent changes, follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Jeanne Cain Rocklin, California	Senior Vice President California Chamber of Commerce
Vincent Mudd Poway, California	President and Chief Executive Officer of San Diego Office Interiors Acting President of the Haworth Dealer Council Acting President of Workplace Alliance, Inc. Acting President of Big Brothers and Big Sisters of San Diego County Executive Board Member of the San Diego Regional Chamber of Commerce Executive Board Member of the San Diego Regional Economic Development Corporation
James Santangelo Long Beach, California	President, Joint Council 42, International Brotherhood of Teamsters Secretary-Treasurer of Local 848
John Rea ^{*(1)} Berkeley, California	Director Department of Industrial Relations
Robert Alvarado ^{*(2)} Pinole, California	Executive Officer Northern California Carpenters Regional Council
Jay Hansen [*] Sacramento, California	Legislative Director State Building & Construction Trades Council

^{*}Ex-officio member

⁽¹⁾ John Rea was replaced by John Duncan in August 2007 as the Director of Industrial Relations.

⁽²⁾ Don Moulds was appointed by the President Pro Tempore of the California State Senate in March 2007 to replace Robert Alverado as a non-voting member of the Board. Mr. Moulds has been the Director of the California State Senate Office of Research since January 2004.

Principal Officers

<u>Name</u>	<u>Title</u>
James C. Tudor Jr.	President ⁽¹⁾
James F. Neary	Executive Vice President
John E. Putnam	Vice President ⁽²⁾
Linda T. Hoban	Vice President ⁽³⁾
Harrison D. Jerome	Vice President ⁽⁴⁾
A. Renee Koren	Vice President ⁽⁵⁾
Nancy A. Obertello	Vice President
George R. Vignolo Jr.	Vice President ⁽⁶⁾
Charles W. Savage	Vice President ⁽⁷⁾
Connie C. Raiche	Vice President
David West	Vice President ⁽⁸⁾
Don L. Smith	Vice President

- ⁽¹⁾ Mr. Tudor was appointed President effective September 13, 2006. He resigned on March 20, 2007. On March 21, 2007 the Board of Directors appointed Lawrence Mulryan as the Interim President. Mr. Mulryan is the former Executive Director of the California Insurance Guarantee Association.

Janet Frank will become the Fund's President effective October 9, 2007. Ms. Frank was previously the Executive Vice President of North American Field Operations for CNA Financial.

- ⁽²⁾ Mr. Putnam was appointed Vice President, effective January 5, 2006 and then appointed as Executive Vice President effective January 1, 2007
- ⁽³⁾ Ms. Hoban was not an officer at December 31, 2006. She was appointed Vice President, effective February 8, 2007.
- ⁽⁴⁾ Mr. Jerome was not an officer at December 31, 2006. He was appointed Vice President, effective March 22, 2007.
- ⁽⁵⁾ Ms. Koren resigned on March 20, 2007.
- ⁽⁶⁾ Mr. Vignolo retired effective July 1, 2007.
- ⁽⁷⁾ Mr. Savage's appointment as the Fund's Vice President and General Counsel was terminated on May 22, 2007. He is currently serving as the Fund's Assistant Chief Counsel.
- ⁽⁸⁾ Mr. West was not an officer at December 31, 2006. He was appointed Vice President effective May 8, 2007.

Corporate Governance

During the review of corporate governance, the following deficiencies and corrective actions were noted:

- 1) The reporting structure for internal and external audit functions does not provide adequate insight and information to the Board of Directors. Lack of communication between the Board and the auditors may result in the Board not being aware of potential weaknesses of the Fund. The Board has taken the following corrective actions since May, 2007.
 - a) The Board established an Audit Committee and a detailed charter that specifies the committee's duties and responsibilities. Members of the committee include Board Chairperson, Jeanne Cain, and Board members, Vincent Mudd and Sheryl Chalupa. The charter requires that the Audit Committee: (1) independently monitor the Fund's financial processes and internal controls; (2) review the work of the Fund's independent auditor; (3) review the Internal Audit Department's (Internal Audit) work product; and (4) ensure that an adequate system of risk evaluation exists in the organization.
 - b) Internal Audit now reports directly to the Audit Committee, and presents reports at every Board meeting without the Fund's management staff present. The Board has approved a charter for Internal Audit that details Internal Audit's responsibilities and mandates unrestricted access to all records and personnel at the Fund. According to the Fund, this charter is an adaptation of the Institute of Internal Auditors' model charter. Internal Audit reports only to the President for administrative matters. Functionally, Internal Audit reports to the Board and the Audit Committee. Internal Audit now has a direct line to the Audit Committee for reporting its findings to the Board.
 - c) Fund management indicated that it is in the process of developing a risk management committee to work in conjunction with Internal Audit. This committee will be responsible for continually reviewing business risks. Its first task will be to commence a full operational risk analysis and to further evaluate internal controls. Through the

work of this committee, the Fund will pursue best practices in these areas as part of its regular operations.

- 2) The Fund's Vice President and General Counsel should not be jointly responsible for the management of the Fund's legal functions and its operational functions. The responsibilities of the Fund's General Counsel should be limited to those of a legal nature, with the other operational functions assigned to the Chief Financial Officer or the Chief Operating Officer. In May 2007, the Board terminated the appointment of the Fund's Vice President and General Counsel. The positions of Vice President and General Counsel are now separate and are responsible for separate functions after the organizational restructuring. As of the date of this report, no one has been appointed to the position of General Counsel.
- 3) The Fund does not have a permanent Chief Operating Officer, Chief Financial Officer (CFO), Chief Information Officer, Chief Investment Officer or General Counsel. The functions of the CFO, including financial forecasting, were split between two consultants. Prior to corrective actions taken by the Fund, the President was responsible for the Fiscal and Investment Services Department, while the Vice President and General Counsel managed functions relating to premium billing and collection. Interim President, Larry Mulryan, hired a consultant, Stephen C. Kolakowski, as the Fund's Interim Chief Financial Officer. As the Fund's Interim CFO, Mr. Kolakowski was charged to assist Mr. Mulryan in evaluating and coordinating all financial and accounting activities. He also has been advising the Fund management and staff in the following departments: Fiscal and Investment Services, Internal Audit, Management Information and Budget, Business Services and Information Technology (IT). Recommendations by the interim CFO include comprehensive changes in expenditure authorization and oversight, budgeting, and internal financial reporting.

It is recommended that the Fund hire a permanent CFO to implement and monitor effective internal controls, and to improve existing functions of accounting, budgeting and financial reporting.

It is recommended the Fund hire a Chief Operating Officer to oversee the executives who direct the activities of various departments within the Fund. The Chief Operating Officer should also be responsible for the implementation of the Fund's policies on a day-to-day basis.

The Fund has historically appointed vice presidents over the IT function who did not have an IT background. Due to the complexity of IT and the rapid changes that are inherent with this function, the role of an experienced Chief Information Officer is critical to the operations of a company the size of the Fund. It is, therefore, highly recommended that the Fund hire a Chief Information Officer charged with, at a minimum, the following duties:

- Developing and implementing, with the assistance of the Executive Committee and program managers, a comprehensive IT strategy to include both current systems and future enhancements required to provide the Fund with the tools necessary to address IT issues critical to the operations of the Fund.
- Reviewing both historical and anticipated future IT expenses of the Fund for the purpose of developing a budget that will address the overall IT strategy as well as company-wide measures that can be implemented to reduce expenses, while maximizing the efficiency of IT.
- Implementing controls to ensure that IT functions within departments of the Fund are reviewed on a regular basis, with recommended corrective actions for improvement.
- Implementing controls to protect the data of the Fund.
- Performing reviews of IT management within the Fund.

With over \$22 billion in invested assets as of December 31, 2006, it is also recommended that the Fund hire a Chief Investment Officer who would be responsible for the management and oversight of the Fund's investment portfolio.

- 4) During the examination period, potential conflicts of interest were noted with two board members, Frank DelRe, who was a board member from November 2003 to November 2006, and Kent Dagg, who was a board member from June 2004 to November 2006. From 1996 to January 2007, the Fund paid over \$140 million in group administrative fees to Western Insurance Administrators, which is controlled by Frank DelRe. For the same period, the Fund paid over \$125 million to associations in which Mr. Dagg had a business relationship. The two Board members resigned in 2006. Although the Board minutes indicated that there was no conflict of interest, the fact that Board members might have

gained monetarily from the Fund's decisions creates the appearance of a potential conflict. Effective October 1, 2007, the groups administered by Western Insurance Administrators will not be renewed by the Fund. It is recommended that the Board take action to ensure that its members do not personally benefit, either directly or indirectly, as a result of decisions made by the Board.

The Fund indicated that corrective actions to be implemented by the Board include the development of a code of ethics policy for board members, officers and employees. This code of ethics will include, among other provisions, articles related to financial conflicts of interest and procedures for investigations of directors and officers concerning ethics complaints. The Fund also indicated that it is in the process of preparing an Employee Incompatibility Activities policy. The Board is scheduled to review and adopt this policy in the later part of 2007.

5) Management of the Fund has not implemented adequate controls over the financial reporting function. Several significant control weaknesses were noted, including the following:

- Ineffective controls over accruals.
- Ineffective controls over the classification of expenses in the Fund's Annual Statement.
- Ineffective controls over the calculation of the provision for reinsurance.

It is recommended that the Fund take the steps necessary to address these control deficiencies.

TERRITORY AND PLAN OF OPERATION

The Fund is authorized to write workers' compensation insurance, including liability under the United States Longshoremen's & Harbor Workers' Compensation Act, in the State of California. It also insures the temporary workers' compensation exposures in other states for California employers insured by the Fund.

Brokers are the primary source of business for the Fund. In 2006, estimated annual premium produced by brokers totaled approximately \$1.9 billion, or 66.2% of the Fund's total estimated annual premium. In 2005, broker produced premium represented 71% of the total estimated annual premium.

The Fund conducts operations from its home office in San Francisco and through a network of fourteen district offices and five state contract offices. The district offices and state contract offices provide claims adjustment and policy services. Customer Service Centers located in Monterey Park and Fairfield provide servicing support for assigned policies. The Customer Service Centers also handle first reports of injury for assigned policies; referrals to medical facilities; and issue premium quotes for assigned renewals. The Fund created three Claims Processing Centers to centralize certain claims functions of the district offices in support of an Electronic Claims File project that was implemented over a period of time from January, 2005 to October, 2006.

GROWTH OF FUND

The Fund is California's leading writer of workers' compensation insurance. The passage of open rating in 1995 marked a significant change in the California workers' compensation market. Beginning in 2000, the Fund's unadjusted market share increased substantially, from 28% in 2000 to 53% in 2003. During this period, a significant number of insurers in the private workers' compensation sector began experiencing financial difficulties, causing a shortage of coverage in the California market.

Major workers' compensation reform legislation was enacted by the California Legislature in 2002, 2003, and 2004. These reforms have resulted in significant decreases in loss costs resulting in the industry's rates declining by 59% over the three-year period from July 1, 2003 to January 1, 2007. The Fund indicated that its rates are now below where they were in 1996. The Fund's unadjusted market share peaked in 2003 at 53%, and then declined to 51% in 2004, 42% in 2005 and 32 % in 2006. The Fund estimates its market share to be approximately 23% for the quarter ending March 31, 2007.

The following schedule reflects the net earned premiums and policyholder surplus as reported by the Fund since the implementation of open rating in 1995, along with the Fund's unadjusted market share:

<u>Year</u>	<u>Net Earned Premiums</u>	<u>Surplus as Regards Policyholders</u>	<u>Unadjusted Market Share</u>
1995	\$1,072,672,421	\$1,594,255,582	Not available
1996	\$ 992,165,959	\$1,643,192,642	Not available
1997	\$1,052,834,844	\$1,643,046,537	21%
1998	\$1,211,115,154	\$1,564,090,082	22%
1999	\$1,242,318,509	\$1,444,341,709	22%
2000	\$1,728,461,860	\$1,350,333,158	28%
2001	\$3,595,208,483	\$1,431,381,866	43%
2002	\$5,359,292,398	\$1,449,361,255	50%
2003	\$7,633,199,935	\$2,085,877,169	53%
2004	\$7,198,319,378	\$2,862,495,032	51%
2005	\$5,946,400,817	\$3,785,052,242	42%
2006	\$3,477,664,650	\$4,496,655,498	32%

This decrease in market share creates challenges for the Fund in managing its overall expense and overhead structure going forward. Due to lower rates offered by private insurers, which could result in the loss of business with favorable loss experience, coupled with the uncertainty of the ultimate impact of the reforms, there is the potential risk for future adverse loss development. Also, the Fund has historically not been able to cut expenses such as employee's payroll/benefits, at the same rate as private insurers, resulting in a higher loss adjustment expense ratio.

REINSURANCE

Assumed

The Fund has had no assumed premium written during the period covered by this examination and has no liability for assumed losses or loss adjustment expenses as of December 31, 2006.

Ceded

Natural Catastrophe Excess of Loss: In 2006, the Fund maintained natural catastrophe reinsurance that covered \$1.8 billion in excess of the Fund's basic retention of \$200 million, per occurrence, for catastrophic events not caused by an act of international terrorism. The catastrophe treaties consist of three layers and cover all business classified as Workers' Compensation and Employers' Liability, including United States Longshore and Harbor Workers' Compensation Act business. The Fund's maximum ultimate net loss under the treaties is \$5 million for any one life in any one occurrence.

Terrorism Risk Insurance Extension Act of 2005: In addition to natural catastrophe reinsurance, the Fund was covered in 2006 for terrorist events, including nuclear, biological, chemical and radiological events, by a combination of private reinsurance and Federal Government coverage (TRIEA). The Fund retains the first \$200 million of aggregate annual losses caused by terrorism. Private reinsurance then provides \$850 million of aggregate annual excess coverage. The Fund's maximum ultimate net loss under these treaties is \$2 million for any one life in any one act of terrorism. TRIEA then provides coverage for foreign acts of terrorism under specified terms. The terrorist event must have a minimum industry aggregate impact in excess of \$50 million. In an event exceeding the industry minimum trigger, the Fund retains liability under TRIEA for its own losses amounting to less than 20% of 2005 direct earned premium. As noted above, private reinsurance provides partial coverage of the Fund's losses within the TRIEA retention. The Federal Government will then pay 85% of losses in excess of the TRIEA retention, subject to an aggregate industry cap of \$100 billion.

Loss Portfolio Transfer: The Fund entered into a loss portfolio transfer agreement in August, 2002. The contract covers workers' compensation losses only. Loss adjustment expenses, employers' liability and USL&H losses are excluded in the agreement. Under this agreement, the Fund ceded certain loss reserves relating to the accident years 1980 to 1998 to XL Capital Ltd. and ACE Ltd. Under the terms of the contract, the Fund retains the first \$950,000,000 of losses. The reinsurance coverage is for 90% of losses in the covered layers. Initially, the reinsurers cover \$1,035,000,000 of the next layer of \$1,150,000,000 of losses. The Fund retains a further layer of \$200,000,000 excess \$2,100,000,000 with the reinsurers covering

\$270,000,000 of a layer of \$300,000,000 excess \$2,300,000,000. The Fund has the sole right to terminate the contract on or after December 31, 2008. Ceded premium under the contract was \$713,452,806 (\$726,952,806 less \$13,500,000 on deposit with the reinsurers).

As a result of this transaction, and in accordance with Statements of Statutory Principles (SSAP 62), the Fund recorded a contra liability against loss reserves of \$1,035,000,000 and a retroactive reinsurance gain of \$319,756,350 included under other income. The special surplus arising from the transaction will be considered to be earned surplus and transferred to unassigned funds (surplus) when cash recoveries from the reinsurers exceed the total consideration paid by the company for the loss portfolio transfer.

Commutation of Ceded Reinsurance: On March 13, 2006, the Fund exercised the "no claim bonus" provision of the 2005 reinsurance treaties, which resulted in a commutation of the 5th through 7th and 9th layers. The no claim bonus clause provides that in the event no claims arise under the treaties, the reinsurer will allow the Fund to commute the treaty, which entitles the Fund to a return premium. The payment of the return premium by the reinsurers to the Fund constitutes the commutation of the treaties, and such payment once effected is regarded as a full and final release of the reinsurers from all liability under the treaties. The Fund received \$38,412,018 of return premium from the reinsurers as a result of this commutation.

ACCOUNTS AND RECORDS

Accrual of Expenses

The Fund's controls over expense accruals are significantly deficient. It was noted that several accounts had either no accruals or inaccurate accruals during the examination period. The Fiscal Department is responsible for recording accruals to the general ledger, and has relied on simple correspondence from certain departments as documentation of the accrual amount without testing the reasonableness or appropriateness of such accruals. For the year ending December 31, 2006, the Fund either did not record an accrual or recorded a significantly lower accrual for items including but not limited to: a) fees due to administrators of its group

business, b) contingent commissions due to brokers, c) liabilities due under information technology contracts, and d) amounts due to consultants.

Although the amount of these accruals were determined to be immaterial, it is recommended that the Fund implement controls to ensure that unrecorded liabilities are identified and correctly calculated for inclusion in the proper accounting period.

Classification of Expenses in the Underwriting and Investment Exhibit

During the review of the Fund's underwriting expenses, the following significant classification errors were noted:

- a) The Fund classifies group administration fees and information technology consulting expenses under the category of Legal and Auditing. The National Association of Insurance Commissioners' (NAIC) Annual Statement Instructions provide detailed instructions on which type of expenses are to be classified as Legal and Auditing. These expenses include:
 - Legal retainers, fees and other legal expenses (except on losses and salvage)
 - Auditing fees of independent auditors for examining records of home and branch offices
 - Cost of services of tax experts
 - Fees of investment counsel
 - Registrar fees
 - Custodian fees
 - Trustees' fees
 - Transfer agent fees
 - Fees and expenses of others than employees, for collecting balances
 - Notary fees

The inclusion of group administration and information technology consulting expenses under the category of Legal and Auditing does not appear to be in compliance with the NAIC Annual Statement Instructions. From 1999 through 2006, the Fund reported approximately \$484 million in group administration fees under this category. Prior to 2004, the Fund did not have a separate general ledger account for information technology consulting expenses and combined these expenses with other legal/audit

general ledger accounts. From 2004 through 2006, the Fund reported approximately \$153 million in information technology consulting expenses.

- b) Under the category of Survey & Underwriting Reports, the Fund includes expenses such as development of Information Technology (IT) systems and IT consulting expenses. Based on a review of payments over \$25,000 that were recorded to the Safety and Underwriting Costs general ledger account from 2004 until July 2007, the Fund reported approximately \$50 million of such expenses.

The NAIC's Annual Statement Instructions provide detailed instructions of which type of expenses are to be classified as Survey and Underwriting. These expenses include:

- Survey, credit, moral hazard, character and commercial reports obtained for underwriting purposes
- Commercial reporting services
- Appraisals for underwriting purposes
- Fire records
- Inspection, engineering, and accident and loss prevention billed specifically
- Literature, booklets, placards, signs, etc., issued solely for accident and loss prevention
- Maps and corrections
- Services of medical examiners for underwriting purposes

The inclusion of expenses relating to the development of IT systems and IT consulting expenses under the category of Survey & Underwriting Reports does not appear to be in compliance with the NAIC Annual Statement Instructions.

Based on the review of the Fund's classification of expenses in its Underwriting and Investment Exhibit, no reliance can be placed on this exhibit. The accurate classification of expenses within this exhibit provides data relied upon by regulators, rating bureaus, actuaries, and the Fund's management. It is recommended that the Fund separately identify and report the group administration fees and information technology consulting expenses as miscellaneous write-ins in the Underwriting and Investment Exhibit. It is also

recommended that the Fund implement controls to prevent future misclassification of these expenses.

Controls Over Encumbrances

The Fund uses the encumbrance feature in the Oracle accounts payable system to record purchase orders, which provides managers with up to date information about available budgeted funds. However the encumbrance feature also allowed former executives of the Fund to direct unused budgeted amounts at year end to other accounts, allowing additional unbudgeted expenditures to be made in the following year. The Board stated it was unaware of this practice, resulting in the lack of transparency in budget information being presented to the Board. The Fund eliminated this practice in 2007. It is recommended that the Fund review all budgeting policies and procedures and implement strict controls over budgeting practices.

Information Systems Controls

During the course of the examination, RSM McGladrey conducted a review of the Fund's general controls over its information systems. As a result of this review, weaknesses were noted in areas such as information security, physical security, logical security, application security, business continuity, and program change controls. The weaknesses noted were presented to the Fund, along with recommendations to strengthen its controls. The Fund should evaluate the recommendations and make appropriate changes to strengthen its information system controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2006

Underwriting and Investment Exhibit for the Year Ended December 31, 2006

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2006

Statement of Financial Condition
as of December 31, 2006

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
Bonds	\$19,584,212,055	\$	\$19,584,212,055	(1)
Real estate	283,541,965		283,541,965	
Cash and short-term investments	2,151,767,645		2,151,767,645	(1)
Receivable for securities	75,000,000		75,000,000	
Investment income due and accrued	207,833,394		207,833,394	
Uncollected Premiums and agents' balances in course of collection	361,018,648	279,611,981	81,406,667	
Deferred Premiums, agents' balances and installments booked but deferred and not yet due (including \$ 94,205,689 earned but unbilled premiums)	105,197,284	10,467,324	94,729,960	
Accrued retrospective premiums	852,813	194,093	658,720	
Amounts recoverable from reinsurers	14,420,099		14,420,099	
Guaranty funds receivable or on deposit	293,092,143		293,092,143	
Electronic data processing equipment and software	81,709,313	76,036,547	5,672,766	
Furniture and equipment	7,449,955	7,449,955		
Aggregate write-ins for other than invested assets	<u>272,703,252</u>		<u>272,703,252</u>	
Total assets	<u>\$23,438,798,566</u>	<u>\$373,759,900</u>	<u>\$23,065,038,666</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Losses			\$15,430,591,956	(2)
Loss adjustment expenses			1,845,183,123	(2)
Commissions payable, contingent commissions and other similar charges			76,091,555	(3)
Other expenses			38,928,624	(4)
Taxes, licenses and fees			16,459,816	
Unearned premiums			131,080,221	
Advance premium			159,814	
Dividends declared and unpaid: policyholders			3,100,000	
Amounts withheld or retained by the company for account of others			76,904,041	
Provision for reinsurance			19,285,683	(5)
Aggregate write-ins for liabilities			<u>930,598,335</u>	(6)
Total liabilities			18,568,383,168	
Aggregate write-ins for special surplus funds		\$ 576,256,350		
Unassigned funds (surplus)		<u>3,920,399,148</u>		
Surplus as regards policyholders			<u>4,496,655,498</u>	
Total liabilities, surplus and other funds			<u>\$23,065,038,666</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2006

Statement of Income

Underwriting Income

Premiums earned		\$3,477,664,650
Deductions:		
Losses incurred	\$2,169,249,310	
Loss expense incurred	695,050,221	
Other underwriting expenses incurred	<u>730,412,704</u>	
Total underwriting deductions		<u>3,594,712,235</u>
Net underwriting loss		(117,047,585)

Investment Income

Net investment income earned	\$ 926,841,948	
Net realized capital losses	<u>(3,196,397)</u>	
Net investment gain		923,645,551

Other Income

Net loss from agents' balances charged off	<u>\$ (127,539,950)</u>	
Total other income		<u>(127,539,950)</u>
Net income before dividends to policyholders		679,058,016
Dividends to policyholders		<u>10,287</u>
Net income		<u>\$ 679,047,729</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2005		\$3,785,052,243
Net income	\$ 679,047,729	
Change in net unrealized capital gains	17,863	
Change in nonadmitted assets	51,799,946	
Change in provision for reinsurance	<u>(19,262,283)</u>	
Change in surplus as regards policyholders		<u>711,603,255</u>
Surplus as regards policyholders, December 31, 2006		<u>\$4,496,655,498</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2006

Surplus as regards policyholders, December 31, 2002, per Examination			\$ 449,361,255
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$4,323,527,859	\$	
Net unrealized capital gains	1,150,527		
Change in nonadmitted assets		258,098,460	
Change in provision for reinsurance	<u> </u>	<u>19,285,683</u>	
Totals	<u>\$4,324,678,386</u>	<u>\$277,384,143</u>	
Net increase in surplus as regards policyholders for the examination period			<u>4,047,294,243</u>
Surplus as regards policyholders, December 31, 2006, per Examination			<u>\$4,496,655,498</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Bonds, Stocks and Short-term Investments

Excess Fund Investments: California Insurance Code (CIC) Section 11797 mandates that the Fund limit its investments to only those permitted under Article 3 (commencing with Section 1170). During the examination period, it was noted that the Fund made material investments which were not in compliance with CIC Section 11797. The Fund continues to invest in securities that are not allowable investments. It is recommended that the Fund limit its investments to those permitted under CIC Section 11797.

Investment Policy: The Fund's written investment policy has not changed in the past nine years. Although the Fund's investment policy is conservative in the types of investment allowed, it should be formally reviewed on a regular basis to consider changes in the investment environment. Additionally, while there are formal investment guidelines between the Fund and its investment manager, such guidelines are very broad and are frequently supplemented by oral instructions as to asset class allocations, duration targets, and concentration limits within the guidelines. It is recommended that the Fund include more specific guidance relating to these areas in the investment guidelines, as well as providing written confirmation of any supplemental instructions. It is also recommended that the Fund review its investment policy on an annual basis, and present the policy to the Board of Directors for approval.

(2) Losses and Loss Adjustment Expenses

A Senior Casualty Actuary of the California Department of Insurance (CDI) evaluated the loss and loss adjustment expense reserves as of December 31, 2006, and has determined that the loss and loss adjustment expense reserves reported by the Fund as of December 31, 2006 were reasonable.

Although the Fund's loss and loss adjustment expense reserves reported as of December 31, 2006 were found to be reasonable in total, the reserves were found to be significantly deficient

for accident years 2003 and prior, and significantly redundant for accident years 2004, 2005, and 2006. The direct loss reserves for accident years 2003 and prior were found to be deficient by approximately \$3.3 billion, while the reserves for accident years 2004 through 2006 were found to be redundant by approximately \$3.2 billion. It is recommended that the Fund redistribute its reported reserves by accident year in order to eliminate these deficiencies and redundancies by accident year.

The CDI's actuary had previously determined, based on an analysis of data through December 31, 2005, that the Fund's reported reserves as of that date were deficient by approximately \$1.1 billion. The elimination of that deficiency as of December 31, 2006 is due to favorable loss emergence on accident years 2005 and prior during 2006 as workers' compensation reforms continue to lower benefit costs on both old and new claims. In addition, the Fund recorded redundant reserves for the 2006 accident year.

Due to recent changes in the claims processing function, such as the transition of the medical payment function from the district offices to Claims Processing Centers (CPC), as well as the implementation of a new Electronic Claims File system, the examination conducted a review to determine the average number of days it takes the Fund to pay claimant's medical bills. The review, which included the period from January 2005 through June 2007, indicated a significant increase in the processing time for medical payments. The average number of days to pay a medical bill has increased from 26 days to 55 days during this period. It is recommended that the Fund implement procedures to address the significant delay in processing its medical bill claims.

The CDI's actuary noted that while the increased delay in medical payments was significant, the majority of the slowdown has occurred in 2007, after the December 31, 2006 valuation date. As a result, the data used in the year-end 2006 analysis is relatively unaffected by the medical payment delays. However, greater attention will need to be paid to this in future analyses.

(3) Commissions Payable, Contingent Commissions and other Similar Charges

During the period covered by this examination, the Fund utilized two commission programs, the Direct Commission Program (DCP) and the Safety Incentive Performance Plan (SIPP), which replaced the DCP. The primary difference between the two programs is that the SIPP program pays 50% of the contingent commission in February of the following year and the remaining 50% one year later, whereas the DCP plan pays 100% of the commission in February of the following year. As of December 31, 2006, the Marketing Department was responsible for both the calculation of commissions as well as issuing payments to brokers.

Based on a review of the above captioned liability account, the following control weaknesses were noted:

- a) The Fund did not record an accrual for this account for the year ending December 31, 2003, resulting in a \$113 million understatement of the commission payable liability. The Fund's accrual for the year ending December 31, 2004 was accepted as reported by the Fund.
- b) After implementing the SIPP commission program in 2005, the Fund recorded an accrual; however, it only recorded the commission due in February of 2006, resulting in an understatement of the liability totaling \$28,214,956.
- c) For the year ending December 31, 2005, the Fund did not record sufficient contingent commissions for earned but unbilled premium (EBUB). Additionally, the accrual reported by the Fund for 2005 was incorrectly reported under other expenses instead of commissions payable. The net under-accrual for EBUB commissions payable in 2005 totaled \$824,819.

The Fund attributed the above errors to miscommunication between the marketing and fiscal departments, more specifically the Marketing Department's lack of understanding of

accounting principles. For the year ending December 31, 2006, the examination did not note any differences in commissions payable.

It is recommended that the Fund delegate the responsibility of accounts payable accruals, such as the accrual for commissions payable, to the Fiscal Department. Additionally, it is recommended that the Fund (1) implement controls to ensure that business functions are reviewed by the Fiscal Department to make certain there is appropriate accounting treatment and (2) establish proper internal controls to ensure that liabilities of the Fund are identified and accrued in the proper accounting period.

(4) Other Expenses

At December 31, 2006, the Fund did not record an accrual for fees due to administrators of the group insurance program. The amount of the fee is based on a percentage of the estimated contract premium for the group and is payable in four installments. During the examination period, the amount accrued versus the actual amount paid subsequent to year-end is summarized in the schedule below:

<u>Year</u>	<u>Amount Accrued for Contract Year</u>	<u>Amount Paid in Subsequent Periods</u>	<u>Under-Accrual</u>
2003	\$ 0	\$ 32,176,555	\$ 32,176,555
2004	3,092,146	36,875,003	33,782,857
2005	0	25,439,617	25,439,617
2006	0	19,248,832	19,248,832

Proper accrual of the fees due to the group insurance administrators would result in an increase in other underwriting expenses. The Fund attributed these accounting errors to miscommunication between the marketing and fiscal departments.

It is recommended that the Fund delegate the responsibility of accruals for the group administration fees to the Fiscal Department. Additionally, it is recommended that the Fund

implement controls to make sure that business functions are reviewed by the Fiscal Department to ensure appropriate accounting treatment.

(5) Provision for Reinsurance

The 2006 provision for reinsurance was accepted as reported by the Fund; however, the 2005 calculation was understated by approximately \$30.7 million. The majority of this understatement was due to the omission of three reinsurers from the provision calculation. It is recommended that the Fund implement controls to ensure that the provision for reinsurance is calculated in compliance with Annual Statement instructions.

(6) Aggregate Write-ins for Liabilities

The Fund has a policy of self-insuring for Workers' Compensation claims made by its own employees. The Fund's loss and loss adjustment expense reserves are estimated by Milliman, Inc., but the Fund establishes the ultimate reserves and reports them under the Aggregate Write-Ins for Liabilities account. In 2004, Milliman's estimates indicated a reserve deficiency of \$63 million. In 2005, the Fund strengthened its reserves by approximately \$63 million to reflect Milliman's estimate. Milliman determined that the Fund's carried reserves at December 31, 2006 were reasonable.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control - Corporate Governance (Page 7): It is recommended that the Fund hire a permanent Chief Financial Officer to implement and monitor effective internal controls, and to improve existing functions of accounting, budgeting and financial reporting.

It is recommended the Fund hire a Chief Operating Officer to oversee the executives who direct the activities of various departments within the Fund.

It is recommended that the Fund hire a Chief Information Officer charged with, at minimum, the duties outlined within this report.

It is also recommended that the Fund hire a Chief Investment Officer who would be responsible for the management and oversight of the Fund's investment portfolio.

It is recommended that the Board take action to ensure that its members do not personally benefit, either directly or indirectly, as a result of decisions made by the Board.

It is recommended that the Fund take the steps necessary to address control deficiencies noted in its financial reporting function.

Accounts and Records – Accrual of Expenses (Page 14): It is recommended that the Fund implement controls to ensure that unrecorded liabilities are identified and calculated for inclusion in the proper accounting period.

Accounts and Records – Classification of Expenses in the Underwriting and Investment Exhibit (Page 15): It is recommended that the Fund separately identify and report the group administration fees and information technology consulting expenses as miscellaneous write-ins in the Underwriting and Investment Exhibit. It is also recommended that the Fund implement controls to prevent future misclassification of these expenses.

Accounts and Records – Controls Over Encumbrances (Page 17): It is recommended that the Fund review all budgeting policies and procedures and implement strict controls over budgeting practices.

Accounts and Records - Information Systems Controls (Page 17): It is recommended that the Fund make appropriate changes to strengthen its information system controls, including such areas as information security, physical security, logical security, application security, business continuity, and program change controls.

Comments on Financial Statement Items – Bonds, Stocks and Short-term Investments (Page 21): It is recommended that the Fund limit its investments to those permitted under California Insurance Code (CIC) Section 11797. Additionally, it is recommended that the Fund: 1) include more specific guidance relating to these areas in the investment policy, as well as providing written confirmation of any supplemental instructions and 2) review its investment policy on an annual basis, and present the policy to the Board of Directors for approval.

Comments on Financial Statement Items – Losses and Loss Adjustment Expenses (Page 21): It is recommended that the Fund redistribute its carried reserves by accident year in order to eliminate the significant deficiencies and redundancies by accident year.

It is also recommended that the Fund implement procedures to address the significant delay in processing its medical bill claims.

Comments on Financial Statement Items – Commissions Payable, Contingent Commissions and other Similar Charges (Page 23): It is recommended that the Fund delegate the responsibility of accounts payable accruals, such as the accrual for commissions payable, to the Fiscal Department. Additionally, it is recommended that the Fund (1) implement controls to ensure that business functions are reviewed by the Fiscal Department to make certain there is appropriate accounting treatment and (2) establish proper internal controls to ensure that liabilities of the Fund are identified and accrued in the proper accounting period.

Comments on Financial Statement Items – Other Expenses (Page 24): It is recommended that the Fund delegate the responsibility of accruals for the group administration fees to the Fiscal Department. Additionally, it is recommended that the Fund implement controls to ensure that business functions are reviewed by the Fiscal Department to ensure appropriate accounting treatment.

Comments on Financial Statement Items – Provision for Reinsurance (Page 25): It is recommended that the Fund implement controls to ensure that the provision for reinsurance is calculated in compliance with Annual Statement instructions.

Previous Report of Examination

Comments on Financial Statement Items – Bonds, Stocks and Short-term Investments (Page 13): It was recommended that the Fund limit its investments to those permitted under California Insurance Code (CIC) Section 11797. The Fund has not complied with this recommendation.

It was recommended that the Fund submit to the California Department of Insurance certain collateral for repurchase agreements between the Fund's agent, Metropolitan West Securities, Inc., and the broker/seller of the repurchase agreements submit these agreements. The Fund has not invested in Tri-Party Repurchase Agreements since May 30, 2003, so at this time there are no custodial agreements for this class of securities.

ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Fund's directors, officers and employees during the course of this examination.

Respectfully submitted,

_____/S/_____
Gordon M. Curtis, CFE, CISA
Examiner-In-Charge
Department of Insurance
State of California